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DERIVATIVES

How Hedge Fund Managers Can Prepare for the Anticipated "End" of LIBOR

By Anne E. Beaumont

Friedman Kaplan Seiler & Adelman LLP

The possibility of a significant change to, or discontinuation of, the London Interbank Offered Rate (LIBOR) has been discussed for some time, but a recent speech by Andrew Bailey, Chief Executive of the U.K. Financial Conduct Authority (FCA),[1] has crystallized the issue. The end to the publication of LIBOR as it is currently known appears to be a certainty.

Given LIBOR's pervasive use by hedge funds and other market participants, the consequences of its permanent discontinuation will be felt – for better or worse – throughout the financial markets. As one market participant recently observed, "a misstep could have substantial consequences for investors globally."[2] This article discusses the possible consequences for derivatives transactions that involve USD LIBOR and are governed by International Swaps and Derivatives Association (ISDA) documentation, while also suggesting five steps that advisers can take today to prepare for this impending change.[3]

The Current Status of LIBOR

Hedge funds and other market participants engage in a variety of derivatives transactions that reference LIBOR, the most common being interest rate swaps. So prevalent is the use of LIBOR in the interest-rate-swaps market that fixed-income commentator Frank Fabozzi has described that market as "[i]n effect . . . a market to buy and sell LIBOR." LIBOR is referenced by an estimated $350 trillion of outstanding financial contracts in maturities ranging from overnight to more than 30 years. In addition, more than $1 trillion in corporate loans, retail mortgages, floating rate bonds and securitized products either directly reference LIBOR or depend to some degree on one or more LIBOR rates.[4]

On July 27, 2017, Bailey gave a speech, entitled "The Future of LIBOR," at Bloomberg London. He announced that, at the FCA's request, the current panel banks for LIBOR have agreed to sustain the benchmark in its present form until the end of 2021. After that date, "[t]he survival of LIBOR on the current basis, as a dynamic benchmark based on daily submissions and updates, could not and would not be guaranteed." What will happen to LIBOR after that time "would be up to the benchmark's administrator – IBA[5] – and the panel banks," Bailey noted.

While Bailey's speech left open the possibility that LIBOR might continue in some form after 2021, the message was clear that, at the very least, there will be some sort of methodological change to LIBOR. "We do not think we will complete the journey to transaction-based benchmarks if markets continue to rely on LIBOR in its current form. And while we have given our full support to encouraging panel banks to continue to contribute and maintaining LIBOR over recent years, we do not think markets can rely on LIBOR continuing to be available indefinitely," explained Bailey. He also noted that "Market participants must take responsibility for their individual transition plans," and encouraged them to begin working on a transition plan to alternative reference rates that are based firmly on transactions.

For more on the history of LIBOR, see "Hedge Fund Managers Must Prepare for Benchmark Regulation" (Feb. 11, 2016).

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Existing Automatic Fallbacks Under the 2006 ISDA Definitions

The contractual provisions implicated by a potential permanent cessation of LIBOR are not well understood by the markets, and it is important to know how they work and their limitations.

As a threshold matter, it should be noted that if changes were to impact only LIBOR's methodology – and not its name – there would be no contractual consequences, as long as LIBOR continues to be published on the same Reuters and Bloomberg screens as before. There may be some potential economic consequences, however, to a change in methodology, as described below.

If, however, LIBOR were discontinued without any market-wide (or other) action, there are two mechanisms in the 2006 ISDA Definitions[6] that might be triggered for transactions where the documentation designates one of the three LIBOR definitions (contained in the 2006 ISDA Definitions) as the applicable rate. One allows for the use of a dealer poll, while the other would use a successor source (Successor Source) as a substitute.

Dealer Polls

Section 7.1 of the 2006 ISDA Definitions defines hundreds of benchmarks. For USD LIBOR, there are three definitions, which vary only in the data source that publishes the rate.[7] They define USD LIBOR as "the rate for deposits in U.S. Dollars . . . which appears on" either one of two screens on Reuters (LIBOR01 or LIBO) or a Bloomberg screen (BTMM), in each case at 11 a.m. London time.[8] The definitions also provide a fallback in case "such rate does not appear" on the specified screen at the specified time. In that circumstance, the applicable rate "will be determined as if the parties had specified 'USD-LIBOR-Reference Banks' as the applicable" rate.

"USD-LIBOR-Reference Banks" is a rate determined by the contractually selected "Calculation Agent" by asking "prime banks in the London interbank market" for quotations of the "rates at which deposits in U.S. Dollars are offered" by these banks and averaging the quotations, as long as at least two are received. If less than two are received, the Calculation Agent is to obtain and average rate quotations from "major banks in New York City" for "loans in U.S. Dollars to leading European banks."[9] There is no additional fallback for a circumstance where quotations cannot be obtained from either prime banks or major banks.

Thus, one option if LIBOR ceases to be published on the designated screen would be to conduct a dealer poll. History suggests that for a permanent discontinuation of LIBOR this is likely to be impracticable and disruptive. For example, in the days and weeks after Lehman's chapter 11 filing, thousands of derivatives counterparties sought market quotations (Market Quotations) – also a type of dealer poll – to use in early termination of transactions (Early Termination) with the debtors. But there were only a few dozen potential relevant dealers (at most), and they were bombarded by so many requests from both customers and other dealers that they could not accommodate them in a timely way. Meanwhile, these same dealers also needed Market Quotations to value and close out their own derivatives portfolios, all during some of the most challenging market conditions in history. As a result, necessary Market Quotations were nearly impossible to obtain, and the close-out process was chaotic and led to numerous disputes.

See "Lesson From Lehman Brothers for Hedge Fund Managers: The Effect of a Bankruptcy Filing on the Value of the Debtor's Derivative Book" (Jul. 12, 2012); and "Lehman Brothers Bankruptcy: ISDA Issues" (Sep. 22, 2008).

The Lehman experience indicates that daily dealer polling is not a viable way to replace LIBOR even for a brief period of time given the massive number of trades potentially at issue. Dealers would not be able to handle the volume of requests, and the polls also could produce varying results across the market – the exact opposite of the consistency LIBOR is meant to offer.

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Designation of a Successor Source

If there is an advance agreement on a replacement rate for LIBOR, the 2006 ISDA Definitions offer a more robust alternative to a dealer poll. Section 7.2(a) defines the official sources for the rates defined in Section 7.1, including "Reuters Screen" and "Bloomberg Screen." Those two definitions both provide that in the event that a rate is not published on the specified screen, there is a fallback to a Successor Source.

The Successor Source must be "officially designated" by the rate's "sponsor," or "designated" by "the relevant information vendor or provider (if different from the sponsor)." Thus, if IBA, as "sponsor" of LIBOR, or Bloomberg or Reuters, as the relevant information vendors,[10] were to designate a particular screen or benchmark as the "successor" to LIBOR, that would apply to all derivatives transactions using the standardized definitions in Section 7.1, which would include most if not all centrally cleared interest rate swaps.

The Successor Source mechanism has been activated in the past, with little fanfare or apparent disruption, most recently in connection with changes to the ISDAFIX benchmark in 2015. When IBA changed ISDAFIX's name to the "ICE Swap Rate" and altered the methodology, Thomson Reuters began publishing ICE Swap Rate data on existing ISDAFIX screens and also launched new screens specifically for the ICE Swap Rate. The two sets of screens, both displaying the same ICE Swap Rate data, ran in parallel for a transition period. Thereafter, the Reuters ISDAFIX screens were discontinued, and the ICE Swap Rate screens were designated as a Successor Source under Section 7.2(b) of the 2006 ISDA Definitions.[11] This approach did not appear to cause meaningful market disruption, although ISDAFIX has a far smaller role in the market than LIBOR.

While the Successor Source provision offers a relatively clean way to address the permanent discontinuation of LIBOR, it has some limitations. The most significant is that it applies only to those transactions that use one of the three standard LIBOR definitions in the 2006 ISDA Definitions, and then only if a Successor Source is designated in advance. For any transaction that uses some other LIBOR definition, the consequences will depend on the specifics of the relevant confirmation or other documentation. Even for a transaction that does use one of the standard LIBOR definitions, if no Successor Source is designated, a dealer poll will be necessary unless the parties can agree otherwise in advance.

For more on ISDA documentation, see our three-part series discussing "Best Practices for Fund Managers When Entering Into ISDAs": Negotiation Process and Tactics (Jan. 12, 2017); Negotiating Event of Default and Termination Event Provisions (Jan. 19, 2017); and Negotiating Collateral Arrangements (Jan. 26, 2017).

Bilateral Agreements

Where the contractual mechanisms to address the non-publication of LIBOR do not apply, parties would need to agree (ideally in advance of any non-publication) on what will happen. Using non-standardized bilateral agreements, however, is not a particularly attractive option.

As ISDA has noted, any solution that is not market-wide creates a form of basis risk. As a result, a market participant's economic outcome may depend on contractual idiosyncrasies and sometimes the goodwill (or opportunism) of other market participants rather than purely economic factors. Like dealer polls, widespread resort to bilateral agreements would largely destroy the uniformity that is one of the hard-won benefits of the current market structure.

A Market-Wide Solution

Because the Successor Source mechanism cannot provide a solution for every transaction and bilateral agreements have their own limitations, a prompt, market-wide agreement on how to deal with the discontinuation of LIBOR would help avoid disruption and disputes.

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One possibility ISDA has suggested is to amend the 2006 ISDA Definitions to change the definitions of LIBOR. Unless otherwise agreed, however, amendments would apply only prospectively, to new transactions. As with any comprehensive solution, this would also require broad agreement on how to amend the definitions.

For "legacy" transactions that already reference LIBOR, ISDA has indicated the possibility of instituting a "protocol" through which market participants can adopt a replacement rate on a portfolio-wide basis. ISDA appears to view legacy transactions as a lower priority than new transactions, although legacy transactions arguably have greater potential for market disruption without a comprehensive solution. Until a LIBOR replacement is identified and agreed upon on a broad basis, however, a market-wide protocol cannot be implemented. Thus, the focus of immediate efforts will be on identifying or developing alternative rates.

Possible Alternatives

A replacement for LIBOR might be a modified and renamed version of LIBOR (as with ISDAFIX), an existing benchmark or a newly created one. It is also possible that LIBOR will be replaced not with a single benchmark but with a variety of rates that more closely match market participants' needs. Indeed, there is no particular economic reason that a rate like LIBOR that accounts for bank credit risk is necessary in every interest rate derivatives transaction.

IBA had at one time indicated that it might launch a "reformed" and renamed LIBOR, but Bailey's recent speech has now cast that into doubt. Meanwhile, at least one new benchmark that might serve as a replacement for LIBOR already is in the works. In June 2017, the Federal Reserve Bank of New York's Alternative Reference Rates Committee "identified a broad Treasuries repo financing rate [(BTFR)], which the Federal Reserve Bank of New York has proposed publishing in cooperation with the Office of Financial Research, as the rate that, in its consensus view, represents best practice for use in certain new U.S. dollar derivatives and other financial contracts."[12] The proposed BTFR is more of a true risk-free rate, which does not take into account bank credit risk as LIBOR did. It lacks a term structure, however, so further refinements would be needed to adapt it for broad use.

Of course, any replacement for LIBOR will, by definition, differ from LIBOR, and even a seemingly minor difference in rate-setting methodology can have significant economic consequences. This is illustrated by the Bank of England's 2016 change to the sterling unsecured overnight interest rate (SONIA) benchmark methodology. After the Bank switched from a volume-weighted mean to a volume-weighted median, that rate moved down immediately by nearly three basis points.[13] Consequently, any LIBOR replacement (whether as a Successor Source or otherwise) will require revaluation of derivatives portfolios, which, in turn, may require changes to hedging strategies as well as potentially significant credit support payments. Substitution of an alternative rate also may affect option exercise decisions and the calculation of periodic swap payments. Indeed, some positions, including basis swaps, will become incoherent without LIBOR and may have to be unwound entirely.

What Market Participants Can Do Now

With any major market change, the keys to avoiding problems and disputes are knowledge and preparation. While ISDA and others determine how to proceed in replacing LIBOR, market participants whose transactions involve LIBOR should take immediate steps to understand how LIBOR replacement might affect their own portfolios. A few steps that can be taken now will help avoid potential future problems.

Review ISDA Documentation

Advisers should locate relevant documentation, including all Schedules, Paragraph 13 documents, confirmations and amendments for each counterparty with whom the adviser has LIBOR-related transactions. All applicable definitions should be reviewed to determine, among other things, how LIBOR is defined

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(including whether the 2006 ISDA Definitions are used and whether it is defined consistently across all transactions) and what (if anything) is supposed to happen if LIBOR ceases to exist.

Consult Counsel

If an adviser is not sure how to interpret its documentation or how its transactions will be affected by LIBOR replacement, it should promptly consult an experienced attorney. An adviser's options will only narrow as 2021 approaches, and any necessary changes may take time to implement, particularly if numerous market participants are also attempting to make changes.

Perform Portfolio Testing

Market participants should analyze how their current portfolios would perform with various potential LIBOR replacements, including new ones as they are identified.

Stay Informed

Advisers should pay attention to news and industry information about how LIBOR replacement work is proceeding. Good sources of information include ISDA's derivatiViews[14] and online Newsroom,[15] as well as the Fed's Alternative Reference Rates Committee website.[16] Advisers should communicate with other market participants – particularly existing counterparties – for information about market developments. Users with idiosyncratic needs may wish to get directly involved in LIBOR replacement efforts through industry groups such as ISDA.

Consider Impact on Future Transactions

Advisers executing new LIBOR-based transactions between now and 2021 will require the same level of attention and analysis as legacy transactions.

Anne E. Beaumont is a litigation partner in the New York office of Friedman Kaplan Seiler & Adelman LLP. Her practice focuses on representation of investment and asset management firms and their managers and investors as well as financial services litigation matters and disputes involving derivatives and other complex financial products and transactions. She also counsels and trains financial services industry clients on legal, compliance, due diligence and other issues, and advises investment and asset managers and their professionals on employment and separation issues.

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[1] The FCA took over regulation of LIBOR in April 2013.
[2] See William G. De Leon and Courtney A. Walker, *No Room for Error: A Misstep in Creating an Alternative to Libor Could Be Costly to Investors*, PIMCO (Aug. 2017).
[3] While this article focuses on how LIBOR is used in ISDA documentation, the issues for other transactions and "IBOR" benchmarks are similar.
[4] *See* "2014 Final Report From Market Participants Group on Reforming Interest Rate Benchmarks" (Mar. 2014).
[5] ICE Benchmark Administration (IBA) is the administrator of LIBOR.
[6] A copy of the 2006 ISDA Definitions is available for download for a fee from the ISDA website.
[7] See 2006 ISDA Definitions Section 7.1(ab)(xxii)-(xxiv).
[8] See id.
[9] See 2006 ISDA Definitions Section 7.1(ab)(xxv).
[10] Section 7.2(a) does not contemplate ISDA itself weighing in on a Successor Source.
[11] It is unclear whether Thomson Reuters or IBA designated the ICE Swap Rate screens as the Successor Source.
[12] *See* "The ARRC Selects a Broad Repo Rate As Its Preferred Alternative Reference Rate" (Jun. 22, 2017).
[13] *See* "Bank of England's Consultation Paper Bank on the Reform of SONIA" (Oct. 2016).
[14] Access to ISDA's derivatiViews is available through the ISDA website.
[15] Access to ISDA's Newsroom is available through the ISDA website.
[16] Access to the Alternative Reference Rates Committee is available through the Federal Reserve Bank of New York's website.

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